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Houston's Conundrum: Closing Its Pension-Funding Gap.

Houston is weathering a prolonged plunge in oil prices, but the city may have an even bigger problem: its pensions.

Though economic growth has only slowed, not stalled, in Texas' largest city, its finances are showing what several investors and analysts describe as warning signs.

Those include a rapidly growing gap in funding its retirement plans for public workers and a limit on its revenue-raising capabilities imposed by a voter-approved cap on property taxes.

The $3.2 billion pension-funding gap is threatening Houston's Aa2 credit rating from Moody's Investors Service, hurting demand for its debt and emerging as an issue in the city's mayoral race.

Moody's this summer warned it may downgrade the city's debt if Houston fails to address its pensions, noting the cap limits the city's financial flexibility.

A downgrade could lower prices for outstanding bonds and increase Houston's borrowing costs at a time when it needs improved infrastructure.

Some investors are backing away from the city's debt, saying there are better deals on similarly rated municipal bonds elsewhere. Guy Davidson, director of municipal investments at AllianceBernstein LP, said his firm trimmed its holdings of Houston's debt earlier this year.

"We want to be compensated for those pension liabilities and at current levels, we don't think we are," he said.

Houston is the latest U.S. city to face threats from credit-rating firms and investors over bulging pension obligations. Investors have grown concerned about state and local governments' ability to address unfunded retirement costs. Examples include Chicago and the states of Illinois and Connecticut, whose unfunded retirement costs have ballooned after investing losses from the 2008 financial crisis and chronic underpayments by policy makers.

Houston's predicament also shows how the decline in oil prices is forcing some U.S. state and local governments to re-evaluate their spending priorities.

Houston residents are reluctant to support any tax increases, including raising the property-tax cap, said Mark Jones, a political-science professor at Houston's Rice University.

At the same time, unsustainable pension costs have contributed to reductions in hiring of police officers and spending on pothole repairs, which have become issues in the mayoral race.

Houston's unfunded pension liabilities grew at a faster clip relative to its revenue than in any of the other 50 largest U.S. local governments rated by Moody's, the firm said in a July report, citing data from fiscal 2013.

The city also projects deficits in coming years despite revenue growth, Moody's said in October.

Before 2001, Houston had enough assets to fund future retirement payouts. But an across-the-board boost to retirement benefits around that time, plus losses from two recessions, have weighed on the city's pension funding. The city now only has about 75% of the funds it needs. That places Houston at the average level of funding among city and county plans, according to Wilshire Consulting.

While the city has paid contractually required amounts to plans for municipal employees and police officers over the past five years, the total falls short of fully funding the systems. A state law overseeing the firefighters' plan has resulted in better funding while reducing the city's financial flexibility, Moody's said.

City officials have argued for greater control over pensions and revenue. Ronald Green, Houston's controller, said that while investors in the city's debt can remain confident they will get paid, the city should act soon to improve its finances.

"You don't fix the roof when it's raining, you fix it when it's dry," he said.

Absent a concerted effort to adjust course, the city is headed toward Chicago-level distress, forced to choose between benefit cuts, tax increases and reduced public services, according to a report by the Houston-based Laura and John Arnold Foundation, which funds research on the fiscal health of public pensions.

Houston's pension parameters are set by state law, adding to the complexity of seeking a solution, while the drop in oil prices could magnify problems more quickly than expected, said Josh McGee, a vice president at the foundation.

Among other concerns, the city's plans assume relatively high investment returns of 8% or above, meaning the funding gap may be understated, said Marc Watts, chairman of the Greater Houston Partnership's Municipal Finance Task Force.

"The new mayor, unless this is addressed, isn't going to have any resources to work with," he said.

Some plan officials said retired city workers aren't the problem. Max Patterson, executive director of the Texas Association of Public Employee Retirement Systems, called such warnings "grossly misleading" and said any discussion of pension changes should be considered in a broader conversation about city finances.

Todd Clark, chairman of the Houston Firefighters' Relief and Retirement Fund, said the plan has met and exceeded its assumed returns historically and the board will make any needed adjustments in consultation with an actuary going forward.

The issue is playing into the mayoral runoff between State Rep. Sylvester Turner, a Democrat, and former Kemah Mayor Bill King, a fiscal conservative.

Mr. Turner, running with the support of the city's three major public-sector unions, said the pension issues should be debated with all stakeholders in concert with the city's other fiscal concerns.

After that, he would consider raising the property-tax cap for public safety or paying down debt.

"In order to be successful in addressing the pension issue, you have to engage in comprehensive financial reform," he said.

Mr. King favors adjusting pensions by offering 401(k)-style defined-contribution plans for new hires. He supports maintaining the cap, saying the city raises plenty of tax money and needs to spend less.

“We’ve got time to turn the boat around and not go over the falls, but we don’t have a long time,” he said.

Houston’s situation highlights the need to address pensions and other fixed costs before they become an economic drag, said John Bonnell, senior portfolio manager of tax-exempt investments with San Antonio-based USAA Investments, which doesn’t own the city’s bonds.

“If they end up doing nothing to address this budget issue, 10 years from now Houston could be facing the same problem Chicago is now,” he said. “I think they have the ability to address their issues prudently, it just hasn’t gotten to the point where they’ve been forced to do it.”

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